INVESTMENT COMPANY INSTITUTE

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July 26, 2018

Hong Kong Securities and Futures Commission Issues "Soft Consultation" Revising Proposed Derivatives Amendments to the Code on Unit Trusts and Mutual Funds

[31300]

July 26, 2018 TO: Derivatives Markets Advisory Committee
ICI Global Trading & Markets Committee RE: Hong Kong Securities and Futures Commission Issues "Soft Consultation" Revising Proposed Derivatives Amendments to the Code on Unit Trusts and Mutual Funds

Yesterday, the Hong Kong Securities and Futures Commission ("SFC") issued a "soft consultation"[1] revising proposed amendments to derivatives regulations in its Code on Unit Trusts and Mutual Funds. [2] The original proposed amendments would impose additional distribution requirements and restrictions on funds based on their derivatives exposure.[3] The soft consultation expands the types of derivatives that can be excluded from the calculation of derivatives exposure for determining which restrictions apply. Although the initial consultation paper only would have excluded derivatives for hedging purposes from this determination, the soft consultation also would exclude derivatives for cash flow management or downside risk mitigation purposes.[4] In addition, the SFC clarifies that funds with derivatives exposure exceeding 50 percent of the fund's NAV (but not more than 100%) would not be deemed to be "derivative products" subject to enhanced distribution requirements, if the portion of derivatives investments in excess of 50 percent is solely attributable to one of several "exempted circumstances."[5]

The SFC issued the soft consultation to industry trade associations in response to comments, including from ICI Global,[6] and requests feedback by August 15. ICI Global will be holding a call with interested members to discuss the document. Please contact Ken Fang (kenneth.fang@ici.org) or Brenda Kathurima (brenda.kathurima@ici.org) **by 30 July** if you would like to join the call, and we will forward the call-in details.

Kenneth Fang
Assistant General Counsel

Attachment

endnotes

[1] The soft consultation takes the form of a slide deck and is attached at the end of this memorandum.

[2] The proposed amendments were set forth in an initial consultation paper issued in December. *See* *SFC*, Consultation Paper on Proposed Amendments to the Code on Unit Trusts and Mutual Funds (December 2017), *available at* http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=17CP8. For a summary of the consultation paper, please see ICI Memorandum No. 31065 (Feb. 1, 2018), available at https://www.iciglobal.org/iciglobal/pubs/memos/memo31065.

[3] In particular, the SFC proposes to impose differing requirements on three categories of funds: plain vanilla funds; derivatives-based funds; and retail hedge funds. The SFC proposes to permit "plain vanilla funds" to invest up to 50 percent of their net asset value in derivatives (exclusive of derivatives used for hedging purposes). The SFC would permit other funds known as "derivatives-based funds" to invest up to 100 percent of their net asset value in derivatives (exclusive of derivatives used for hedging purposes), provided they provide additional risk disclosures. Finally, the SFC would permit retail hedge funds to invest in derivatives without any limit, subject to enhanced requirements, including a minimum initial subscription of at least $50,000 US.

The SFC would impose additional requirements on derivatives-based funds and retail hedge funds. Specifically, the SFC would treat derivatives-based funds and retail hedge funds as "derivative products" subject to enhanced distribution requirements under 5.1A and 5.3 of the Code of Conduct for Persons Licensed by or Registered with the SFC. Those provisions would impose additional know-your-client assessments when selling those products on persons licensed by or registered with the SFC. In addition, the SFC would require both derivatives-based funds and retail hedge funds to provide additional plain language disclosure about the risks associated with derivatives and the risk management policy and methods employed to measure and manage derivatives risks.

[4] UCITS would determine their derivatives exposure under the approach of their home rules.

[5] These "exempted circumstances" are for: (i) hedging purposes; (ii) cash flow management or downside risk mitigation; (iii) market access or exposure replication (without incremental leverage at the fund portfolio level); (iv) interest rate strategies qualifying for duration netting rules; or (v) investment in convertible bonds (without stripping out the embedded derivatives).

[6] For a summary of ICI Global's comments on the consultation paper, please see ICI Memorandum No. 31143 (Mar. 23, 2018), available at https://www.ici.org/my_ici/memorandum/memo31143.